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Are Corporate Actions being Treated Fairly?

The relationship between the financial markets and the investor is quietly, but fundamentally, changing. William Rouse, Associate Director Sales, Contemi Solutions discusses the impact of this legislation on financial institutions, the costs of corporate inaction, automation and the evolution of communication lines between firms and clients.

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THE RELATIONSHIP BETWEEN THE FINANCIAL MARKETS AND THE INVESTOR IS QUIETLY, but fundamentally, changing. A series of regulatory changes has or will require clients to be treated fairly (TCF), ensure they are better informed (MiFID II), and fully encouraged to participate in the long-term sustainability of the assets they own (SRD II).

Each of these initiatives has a clear implication to the way organisations approach both the risks and processes involved in the provision of corporate actions servicing. Failure to notify a client of a corporate event which affects their investments or process it fairly, to not report eligible, event generated transactions to the relevant authorities, or to not facilitate proxy voting on request, will not only earn the attention of regulators but could eventually lead to claims for compensation.

The costs of corporate inaction

Quantifying the value of the financial risk in this intensely scrutinised landscape is almost impossible. No single firm is going to stick its head above the parapet and admit to actual or potential losses. Suffice to say that sizable slush funds have been set up, which is a clear indication of its importance and the potential scale of the issue.

On the other hand, reputational risk resulting from inadequate approaches to corporate actions is more tangible. A negative judgment by regulators would immediately call into question the reliability of the firm and raise a red flag to current and prospective clients. Once news hits the rumour mill, competitors may then seize the opportunity to entice those clients away.

SRD II has created a new risk; that of time. The regulations place very strict and exceptionally tight time constraints on all market participants for the management of ownership and proxy voting notifications. The only sustainable solution is effective automation, which is not particularly prevalent in corporate actions processing.

An additional risk to consider is the possible impact of inadequate systems and automation on staff retention. Much of the supporting process will be housed in the back office, which the front office managers rely on to effectively service their clients. If these, and the associated technology, are flawed or insufficient, there is a very real risk that this could trigger senior executives to move to a firm with more robust support.

Diagnosing risk

The key to mitigating financial and reputational risk is found in the firm's operations. As ever, the ability to address risk depends on understanding where it comes from. In the case of processing corporate actions, there are three distinct possibilities. The first is that the firm will completely miss an event. This could be through a failure to monitor generally available information or, more likely, failure to receive a notification from the accredited registrar or custodian. This highlights a broader risk of having multiple people in the chain - where more people equate to greater risk.

The second is failing to understand which corporate actions are relevant to which client and, therefore, to communicate them to all affected parties. However, because each client is different, there is no single template approach.

THIS ONLY LEAVES THE QUESTION - IS THE BENEFIT OF PROCESSING CORPORATE ACTIONS PROPERLY WORTH THE INVESTMENT TO OVERCOME THE CHALLENGES INVOLVED? FOR THE OVERWHELMING MAJORITY OF FIRMS, THE ANSWER IS A RESOUNDING 'YES!'

Some firms tackle this by segmenting clients according to similarities in their characteristics. This may involve categorising them as discretionary, advisory and execution-only in order to help manage the notification process. For discretionary clients, it is likely the firm will always need to notify the discretionary fund manager or an investment committee; for advisory clients, firms still have a responsibility to send notifications on latest developments; and for execution-only clients, firms need to tackle another layer of complexity. If these clients are just trading through the wealth management firm, there is no obligation to notify them about a corporate action. However, when the firm holds the relevant stock in nominee for their client, notification is required.

The reality is that not all firms will follow this approach; many will, instead, segment according to the type of corporate action. This might include different approaches for rights issues versus takeovers. In the case of a rights issue, for example, it may be that broking

firms need to send a message that indicates how much stock is being taken up. When a takeover offer is on the table, it could be that a firm has to record the amount that needs to move into escrow. A portfolio or investment manager should be able to see if something they are considering buying or selling is subject to corporate action. This requires more than simply knowing who holds what stock - there is the wider context to consider.

Finally, a firm need to ensure it proactively manages client responses. Making sure no responses are missed is one part of this. Another is making sure clients actually do respond. It could be argued that if a client fails to acknowledge or respond to a notification, he or she has no further claim on the firm. However, best practice - and the dictates of good service - suggests that reminding clients and giving them a second chance to respond is a positive step.

Life-saving operations

It is clear that firms must manage various scenarios, so it is important that tried and tested processes are used to ensure the correct clients are notified about all relevant corporate actions. This must extend to include making the required elections and then proving that the firm followed the appropriate procedures. To do this, they need to establish the means to assess each client's portfolio and match it against any notification of corporate actions. They then have to establish the right administrative back office processes to ensure decisions are actioned.

While segmentation is an important tool, taking a holistic approach to corporate actions is vital. Rather than simply considering each corporate action individually, firms must have access to data affecting the entire portfolio. This requires information to be widely available to portfolio managers, relationship officers and investment managers so they are well informed on whether to buy or sell across a variety of stocks.

Automating the response

The key to achieving this lies in automation - whether that's between the front and back office or between the front office and the clients. However, corporate actions are traditionally an area without a great deal of this automation. The problem is that manual processing and spreadsheet dependency often lack efficiency and reliability - and, crucially, scalability.

Being able to scale is vital in light of the growing volumes of corporate action notifications. When the number of corporate actions doubles, so too does the workload. Correcting errors and omissions may eliminate financial risk but, on the downside, it becomes a significant overhead in its own right. Corporate scalability - and so sustainability - demands some kind of change. Therefore, automation is becoming unavoidable.

For some, that automation may tie in with efforts to gather and cleanse data from multiple sources. For global firms receiving numerous feeds, this data scrubbing to provide a golden source is crucial and therefore the costs involved are justified. However, for firms receiving just a few copies of the data, this becomes less of an issue and instead the focus must be on the process - in particular how that data is engaged with and disseminated across the firm.

Automation plays a vital role in this. It helps provide a complete picture across the firm including the back office, where better integration can lead to more efficient day-to-day processes. Essentially, the more information that is shared, the better informed the process and, therefore, the investment decision.

Ultimately, an effective approach is to automate where this does not already exist and then better define the processes around it. However, this need not be the labour and cost-intensive solution that some might fear. Instead, firms can introduce systems that keep costs down by focusing on the essentials and targeting the main areas for improvement.

At a time of unprecedented change, when recurring demands are made on firms' data management, processing and reporting capabilities, nobody wants to add to their operational burdens. Fortunately, the corporate action challenge is readily solved without sinking money into cumbersome systems.

This only leaves the question - is the benefit of processing corporate actions properly worth the investment to overcome the challenges involved? For the overwhelming majority of firms, the answer is a resounding 'yes!' ■